# Alternate Investment Funds ('AIFs') - Corporate Governance Aspects

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# Fact!

- Indian AIF industry is standing at 6.9 lakh crores as on 30.06.2022.
- The industry has grown almost by 2 lakh crores in a year.
- Category – II is the biggest of all, constituting almost 81 per cent of total commitments raised.

Source: SEBI

## Learning Objective

- ❑ Understanding AIFs
- ❑ Manner of working of an AIF
- ❑ AIFs – Need for governance norms
- ❑ Governance norms under AIF Regulations
- ❑ Stewardship Code
- ❑ Taxation Aspects
- ❑ Recent cases

# 1 Understanding AIFs

# Overview

- AIFs are privately pooled investment vehicle
- Collect funds from investor and invests such money in accordance with well defined investment policy
- Enables investor to invest in a manner different from traditional modes of investment
- Alternate investment industry began to take shape in 1950s in developed countries
- AIFs provides unique set of attributes that are not generally found in traditional mode of investments which include following characteristics: long term, high risk, or illiquid investments that are associated with higher returns; low correlation with traditional assets to deliver diversification benefits; and scalability

# Background of AIF Regulations

Accordingly, SEBI notified the Alternative Investment Fund (AIF) Regulations – on 21 May, 2012 to govern unregulated entities and create a level playing ground for existing venture capital investors.

SEBI noted the need for comprehensive regulations to deal with investments that are sourced from diverse parts of the private pool of capital.

Private equity funds, real estate funds and many other funds started using VCF route as registration was not mandatory and were not subject to investment restriction

SEBI framed the SEBI (Venture Capital Funds) Regulations, 1996 encouraging investments in start-ups and mid-size companies

# Definition of AIF

- Any fund established or incorporated in India;
- In the form of a trust or a company or a limited liability partnership or a body corporate;
- Privately pooled investment vehicle;
- Collects funds from investors, whether Indian or foreign;
- Invests it in accordance with a defined investment policy for the benefit of its investors

Except –

- Family trusts
- ESOP trusts
- Employee welfare trusts or gratuity trusts
- Holding companies
- Any such pool of funds which is directly regulated by any other regulator in India

# Categories of AIF

## Category I AIFs

- Positive spill over effect
- Invests in start-ups or early-stage ventures
- Supported by government
- Includes VCFs, SME funds, infra funds, etc.

## Category II AIFs

- Funds other than Category I & III AIFs
- Does not undertake leverage, other than operational requirements
- Includes private equity funds, debt funds, etc.

## Category III AIFs

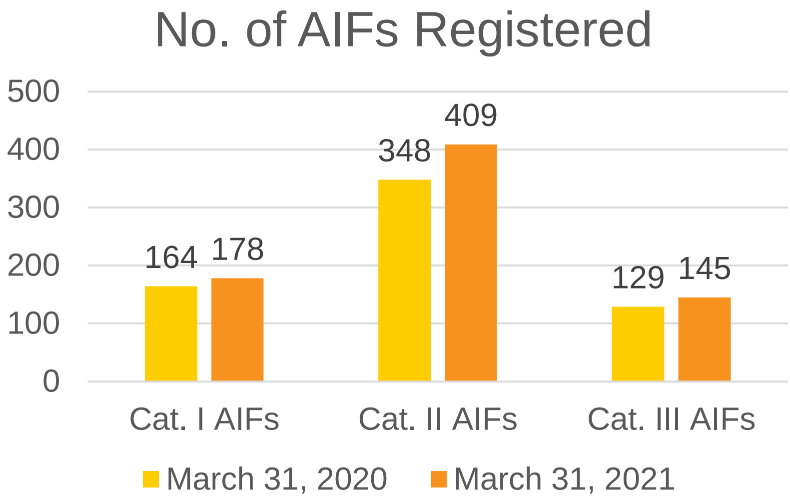
- Employ diverse and complex diverse trading strategies
- May employ leverage
- Funds which trade for short term capital appreciation also included.
- Includes hedge funds, long only funds, etc.

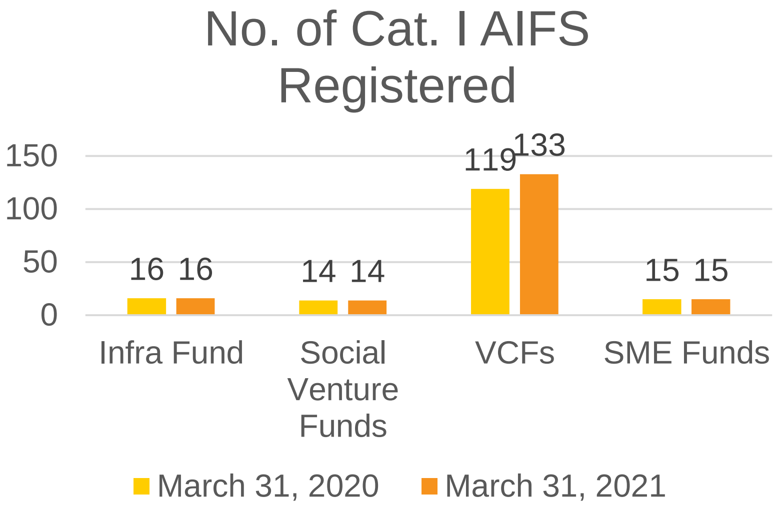
# Comparision between AIFs

| Particulars | Category I | Category II | Category III |
|---|---|---|---|
| Tenure | Close-ended with a minimum tenure of three years | Close-ended with a minimum tenure of three years | Can be either open or close-ended |
| Where can they invest | Invests in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable. Fund of Category I AIFs may invest in units of Category I AIFs of same sub-category or in units of Category II AIFs as specified in the regulation | Invest primarily in unlisted investee companies. Fund of Category II AIFs may invest in units of Category I or Category II AIFs as specified in the regulation | Invest in securities of listed or unlisted investee companies or derivatives or complex structured products. Funds of Category III AIFs may invest in units of other AIF i.e., either Category I, Category II or Category III AIFs |
| Maximum investment per investee company | 25% of investible funds | 25% of investible funds | 10% of investible funds |

# Units of close ended AIFs may be listed; minimum trading lot of Rs. 1 crore*

# Number of Registered AIFs (category-wise)




Source: SEBI Annual Report

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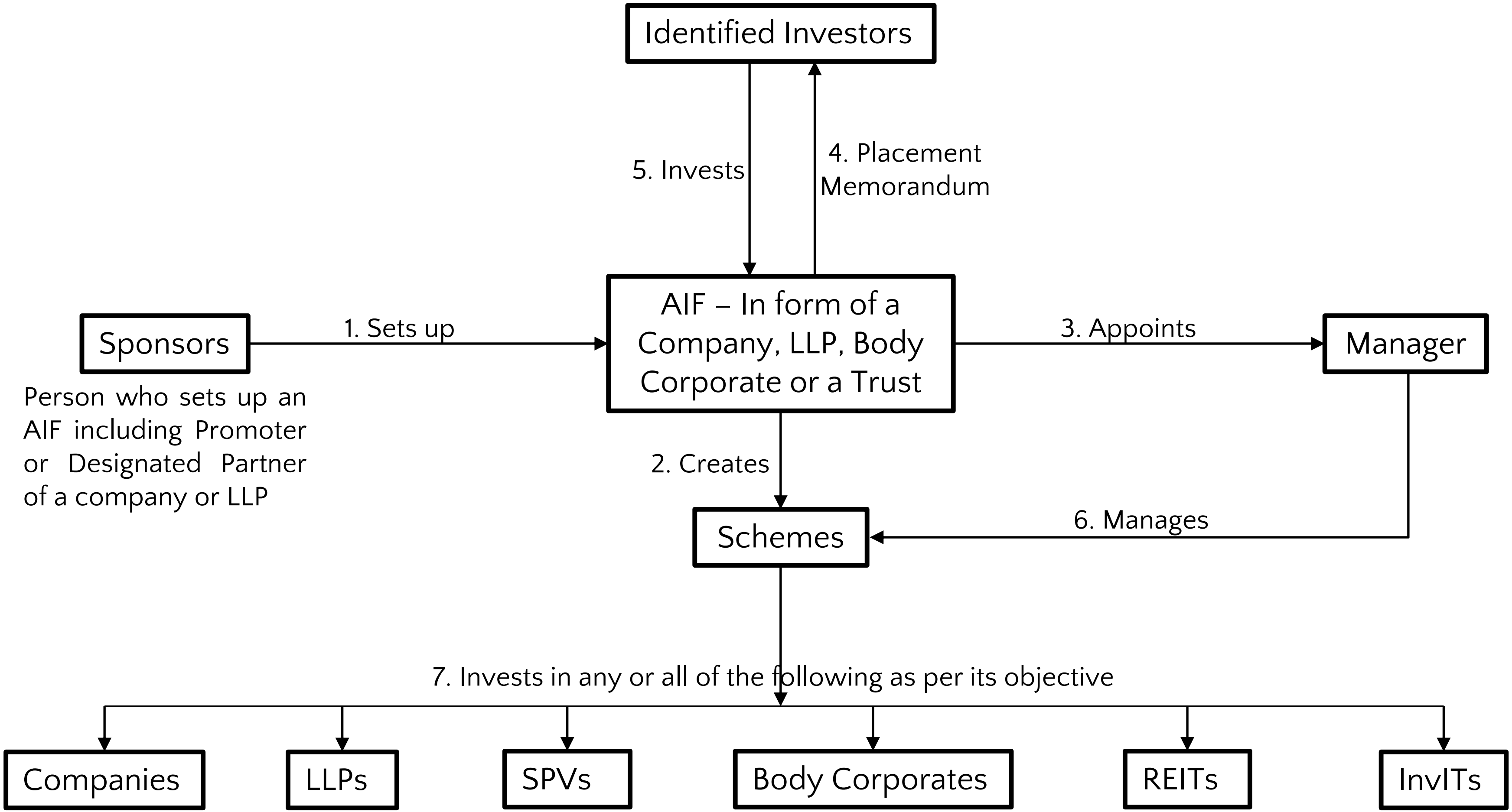
# Manner of working of an AIF


Identified Investors
5. Invests
4. Placement Memorandum
Sponsors
1. Sets up
AIF – In form of a Company, LLP, Body Corporate or a Trust
3. Appoints
Manager
Person who sets up an AIF including Promoter or Designated Partner of a company or LLP
2. Creates
Schemes
6. Manages
7. Invests in any or all of the following as per its objective
Companies
LLPs
SPVs
Body Corporates
REITs
InvITs

3

# AIFs – Need for governance norms

Itself a financial product and legal entity

Complex fiduciary relationship

Managers are generally separate legal entity

Managers and Investment committee takes crucial decision

Approx. 90-95% AIFs are in form of trust

Better investor protection and creation of brand image

Prevents untimed and early investor exit

4

# Governance norms under AIF Regulations

# Classification of governance norms

- DUTIES OF FUND MANAGER/ SPONSOR
- APPROVAL FROM UNIT HOLDERS
- REPORTING REQUIREMENTS
- OTHER GOVERNANCE NORMS

# Duties of fund manager / sponsor

- Key investment team to have adequate experience and professional qualification
- Continuing interest in AIF to be maintained
- Co-investment of manager and sponsor, shall not be on more favourable terms than AIF
- Investment committee to take investment decisions
- Prior approval from SEBI for change in control of manager or sponsor
- Any conflict of interest to be disclosed to investors
- Compliance officer to be appointed for compliance with the provisions

# Approvals from unit holders

1. Extending tenure of close ended schemes

2. Any material alteration to the fund strategy

3. Appointing an external member in investment committee

4. Enhancing time gap between valuations

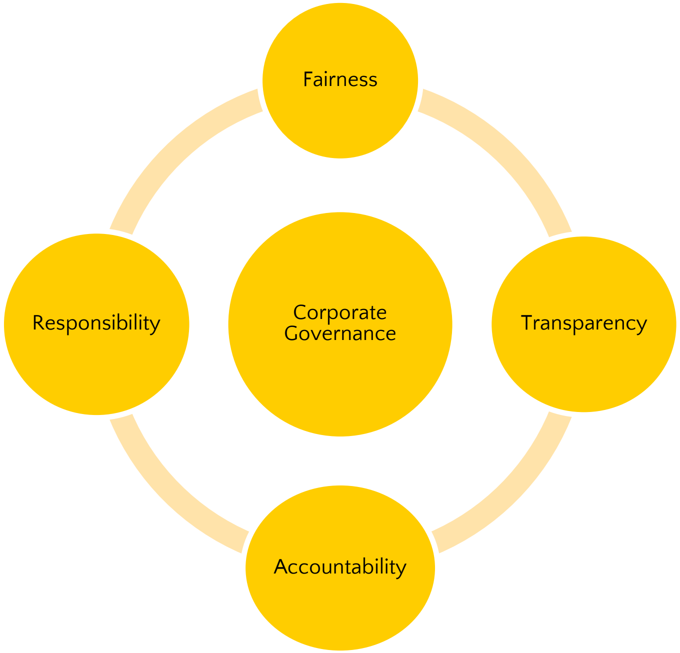
5. In specie distribution of assets of AIF

6. Investment in associates or units of AIF under common control

Note- Except for point 1 & 2 which require approval of 2/3 unit holders by value of their investment in the AIF, all the other given actions require approval of at least seventy five percent of the investors by value of their investment in the AIF

# Reporting Requirements

- Quarterly reporting on activity of all AIFs to SEBI
- Quarterly reporting on leverage undertaken by Category III AIFs to SEBI
- Annual report to investors for Category I & II AIFs
- Quarterly report to investors for Category III AIFs
- Half yearly valuation of investments of AIF for Category I & II AIFs
- Disclosure of NAV to investors for Category III AIFs
- Other event based disclosures



# Other governance norms

Disclosures in Placement Memorandum

Due diligence certificate from merchant banker while filing placement memorandum with SEBI

Risk management framework for Category III AIF

Compulsory audit of accounts

## 5. Stewardship Code for all AIFs

- Stewardship generally means the job of supervising or taking care of something
- Institutional investors are expected to shoulder greater responsibility towards their clients/ beneficiaries
- This can be achieved by enhancing their monitoring and engagement with their investee companies
- These activities are referred to as 'Stewardship Responsibilities' of institutional investors and are intended to protect and improve their client wealth
- This can be seen as an important step towards improved corporate governance of investee companies and hence protecting interest of retail investors in such companies

## Stewardship Principles

- **Principle 1** – Institutional Investors should formulate a comprehensive policy on the discharge of their stewardship responsibilities, publicly disclose it, review and update it periodically.
- **Principle 2** – Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
- **Principle 3** – Institutional investors should monitor their investee companies.
- **Principle 4** – Institutional investors should have a clear policy on intervention in their investee companies. Institutional investors should also have a clear policy for collaboration with other institutional investors where required, to preserve the interests of the ultimate investors, which should be disclosed.
- **Principle 5** – Institutional investors should have a clear policy on voting and disclosure of voting activity.
- **Principle 6** – Institutional investors should report periodically on their stewardship activities.

# 6. Taxation Aspects of AIFs

- For category I & II AIFs, PGBP income is taxable in hands of AIF and exempt in hands of investors. Any income other than business income is exempt from tax in hands of AIF and taxable in hands of unit holders.
- Losses from business and profession are set off and carry forward by AIF, however other losses are passed through to investors to be able to set-off and carry forward while computing their income.
- Category III AIFs has not yet been accorded a pass through status, which means that income from such funds will be taxed at the investment fund level and the tax obligation will not pass through to unit holders.

# Thank You!